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**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF IDAHO**

IN RE

TERRY HIPWELL,

Debtor.

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Case No. 96-02095

MEMORANDUM OF DECISION

Howard R. Foley, FOLEY & FREEMAN, Meridian, Idaho,
for Debtor.

Richard C. Boardman, PENLAND MUNTHERR BOARDMAN,
CHARTERED, Boise, Idaho, for The Amalgamated Sugar
Company.

Ronald D. Schoen, Payette, Idaho, Chapter 12
Trustee.

Background.

Before the Court for decision is a Motion for
Turnover and Objection to Claim filed by the Chapter 12
Debtor Terry Hipwell directed against the creditor The
Amalgamated Sugar Company. The matter came on for hearing
before the Court on March 3, 1997. At the conclusion of the
hearing, the Court took the matters under advisement.

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Facts.

Debtor grew sugar beets on farm land located in Owyhee and Payette County. In 1994 and 1995, Debtor's sugar beet operations were financed by The Amalgamated Sugar Company ("TASCO"). Separate financing agreements between Debtor and TASCO, consisting of a Loan Agreement and Disclosure Statement, Security Agreement, and Memorandum of Agreement, were executed to cover each of the Payette and Owyhee County farms. These agreements governed the parties' relationship, including crop financing, product delivery, calculation and disbursement of crop proceeds, defaults, and remedies. Where appropriate, these agreements are referred to herein as the Payette County Agreements and the Owyhee County Agreements.

Under both agreements, TASCO was to make advancements, consisting of beet seed or money, to be used by Debtor in the production of his sugar beet crop. At harvest, the beets are sold and delivered to TASCO at its receiving station. If upon sale a beet crop generated a net gain, meaning that the amount of crop sale proceeds exceeded advancements, TASCO was to pay out that excess to Debtor over the course of the following year in agreed install-

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ments. In effect, then, the amounts advanced by TASCO to Debtor to produce a crop constituted part payment for the beets grown and sold to TASCO. The amount of an installment payment is determined, in part, by the quality and quantity of the grower's beets, and the current market price of beet sugar.¹ The dates of payment of the deferred installments is also dictated by the agreements.

If, on the other hand, the harvested crop generates a net loss, meaning the amount advanced exceeds the crop sale proceeds, Debtor becomes indebted to TASCO for such loss. Upon Debtor's default in payment of a deficiency, the agreements give TASCO the right to setoff any amounts owing to Debtor against Debtor's indebtedness to TASCO.²

¹ TASCO processes beets throughout the year in order to regulate supply and, thereby, stabilize the price of beet sugar. This benefits both TASCO and the contract growers. Because the beets are processed throughout the year, installment payments are calculated at the time of disbursement using the current market price of beet sugar at the time of payment.

² In the agreements, Debtor also grants TASCO a security interest in his crops and proceeds to secure payment of any balance due to TASCO for advancements.

The 1994 Payette County operation, financed in part by TASCOCO advancements, resulted in a net loss. The 1994 loss of \$63,397.70 was rolled, or carried over, into the 1995 Payette County agreements. In 1995, Debtor's Payette County farm again produced a net loss. At the end of the 1995 growing season, Debtor's accumulated total net loss on the Payette County farm for unreimbursed advancements was approximately \$105,867.62.³ Under the 1995 Payette County Agreements, Debtor was indebted to TASCOCO for that amount.

In 1995, Debtor's Owyhee County operation produced a net gain. Under the Owyhee County Agreements, then, TASCOCO issued a series of installment payments to Debtor in early and mid 1996. TASCOCO was scheduled to distribute a final installment payment to Debtor of \$25,293.24 on the 1995 Owyhee County crop in October, 1996. On August 23, 1996, prior to the receipt of the final installment payment, Debtor filed for Chapter 12 relief.

³ See Growers Accounting Statement attached as Exhibit B to Debtor's Memorandum in Support of Motion for Turnover filed February 27, 1997. The total amount due on this agreement from Debtor to TASCOCO is in dispute. In this decision, the Court is not issuing binding findings on the amount of such indebtedness.

On September 24, 1996, TASC0 filed a proof of claim in the amount of \$105,561.09 in Debtor's bankruptcy proceeding. TASC0's claim arises out of several other agreements between the parties, unrelated to the Payette and Owyhee County Agreements, entered into in 1994, 1995, and 1996. According to the documents submitted with the proof of claim, TASC0 has a perfected security interest in Debtor's equipment and several vehicles.

On October 25, 1996, after Debtor filed his bankruptcy petition, TASC0 issued to Debtor a Growers Accounting Statement for the Payette County property on which Debtor had suffered the net loss.⁴ As evidenced by the statement, TASC0 had applied \$8,788.01 in beet proceeds against the indebtedness, thereby arriving at the \$105,867.62 figure. The proceeds were derived from the 1995 Payette County beet crop.

On February 18, 1997, Debtor filed the present Motion for Turnover and Objection to Claim. Debtor argues that the final deferred payment under the Owyhee County Agreements, and the Payette County beet proceeds applied

⁴ See *supra* note 3 and accompanying text.

against the Payette County indebtedness, are property of the bankruptcy estate and recoverable under Section 542. In addition, Debtor challenges the amount due as stated in the proof of claim. TASC0 opposes the motion and objection. TASC0 claims that Debtor is not entitled to the funds at issue because under the terms of the Payette and Owyhee agreements, and the facts of this case, it has an enforceable right to setoff the amounts due to Debtor under the Owyhee County Agreements against Debtor's other indebtedness to TASC0 pursuant to Bankruptcy Code Section 553. In addition, TASC0 contends that it was entitled to apply the Payette County beet proceeds against the Payette County indebtedness under the equitable doctrine of recoupment. Debtor contends that neither defense is available to TASC0 under these facts.

Discussion.

Section 542 of the Bankruptcy Code, governing turnover of property to the bankruptcy estate, requires creditors to pay to the trustee or debtor-in-possession any debt that is property of the estate and that is matured, payable on demand, or payable on order . . . except to the extent that such

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debt may be offset under section 553 of this title against a claim against the debtor.

11 U.S.C. § 542(b). Section 553, in turn, sets forth a general rule, with certain exceptions not applicable here, that

this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case. . . .

11 U.S.C. § 553(a).

Section 553 does not by itself create a right to setoff (also called "offset"). Instead, it merely acknowledges the continuing vitality of the right to offset mutual prepetition debts in a bankruptcy case to the extent such would be allowed under nonbankruptcy law. In *re Harmon*, 188 B.R. 421 (9th Cir. B.A.P. 1995). In order to invoke Section 553, a right to setoff must exist under nonbankruptcy law, and the debts sought to be offset must be mutual prepetition obligations arising from different transactions. *Citizens Bank of Maryland v. Strumpf*, ___ U.S. ___, 116 S.Ct. 286 (1995); *Newbery Corp. v. Fireman's Fund Ins. Co.*, 95 F.3d 1392 (9th Cir. 1996); In *re HAL*,

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Inc., 196 B.R. 159 (9th Cir. B.A.P. 1996); *In re Club Wholesale Concepts, Inc.*, 94 I.B.C.R. 213, 216. The burden of proving an enforceable right of setoff rests with the party asserting that right, here TASCO. *Newbery Corp.*, 95 F.3d at 1399.

In this case, the source of TASCO's nonbankruptcy right to setoff is the agreements entered into by the parties. The Payette and Owyhee County Agreements each contain the following provision:

6. Remedies. All obligations secured hereby shall be immediately due and payable upon default hereunder, and Secured Party [TASCO] shall have all of the remedies under the Uniform Commercial Code, or other applicable law, of the State where the above real property is located, including:

e. Secured Party [TASCO] shall have the right immediately and without further action by it, to setoff against the obligations of Debtor all money owed by Secured Party [TASCO] in any capacity to Debtor, whether or not due, and Secured Party [TASCO] shall be deemed to have exercised such right of setoff and to have made a charge against any such money immediately upon occurrence of such default even though such charge is made or entered on the books of Secured Party [TASCO] subsequent thereto.⁵

⁵ See Security Agreement dated April 13, 1995, relating to the Owyhee County property, and Security

The agreements permit TASCO to withhold the installment payment due under the Owyhee County Agreements and apply it against Debtor's indebtedness under the Payette County Agreements upon Debtor's default. Here, Debtor defaulted upon his failure to produce and deliver a sufficient crop on the Payette County property to generate proceeds from which to satisfy the advancements from TASCO. Thus, under the agreements, TASCO has the contractual right to setoff amounts it owes Debtor under the Owyhee County Agreements against Debtor's obligations to TASCO under the Payette County Agreements.

The next requirement under Section 553(a) is that the debts sought to be offset must be "mutual." For purposes of Section 553, mutuality is satisfied when the "parties [] have full and concurrent rights against each other." *E.g., In re Lares*, 95 I.B.C.R. 264, 265-66 (citations omitted). In other words, mutuality of obligations requires simply that "something must be owed by both sides." *Id.* at 266. In this case, the parties

Agreement dated March 28, 1995, relating to the Payette County property, attached as Exhibits D and E, respectively, to Debtor's Memorandum in Support of Motion for Turnover filed February 27, 1997.

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obligations are mutual. Debtor is indebted to TASCO under the Payette County Agreements, and TASCO is obligated to Debtor under the Owyhee County Agreements.

The final requirement under Section 553 is that the mutual obligations arose prepetition. Debtor does not dispute that its obligation to TASCO under the Payette County Agreements arose prepetition. Debtor contends, however, that TASCO's obligation under the Owyhee County Agreements arose after bankruptcy. Debtor reasons that, although the contracts were executed and the sugar beets delivered prepetition, the amount owing to Debtor under the final installment payment could not be, and in fact was not, ascertained or calculated until after the bankruptcy filing.

For setoff purposes, a debt that is contingent and unliquidated at the time of the bankruptcy filing will nonetheless be deemed to have arisen prepetition if the right to payment arose before the filing. See *Newbery Corp.*, 95 F.3d at 1398 (stating that claim may be set off without regard to whether it is contingent or unliquidated); *In re Claar*, 93 I.B.C.R. 104, 104-105 (concluding that even though debt was contingent and unliquidated it existed prepetition and therefore complied with the requirements of

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Section 553). Therefore, the crucial date is that on which the right to payment arose. When parties enter into a contract prior to bankruptcy, any future right to payment accrues at the time of contracting, even though the establishment or determination of the amount owed under the contract occurs postpetition. See, e.g., *In re Claar*, 93 I.B.C.R. at 104-105; *United States v. Gerth*, 991 F.2d 1428, 1433-34 (8th Cir. 1993); *In re Women's Technical Institute, Inc.*, 200 B.R. 77, 83-84 (Bankr. D. Mass. 1996). In other words, a claim is not transformed from a prepetition claim to a post-petition claim simply because it can not be computed until after the petition is filed. *In re United Sciences of Am., Inc.*, 893 F.2d 720, 724 (5th Cir. 1990).

TASCO's claim against Debtor stems from the agreements between the parties entered into some 16 months before the bankruptcy filing. An obligation for payment accrued at the time the parties executed the agreements in which Debtor promised to pay TASCO for any net loss. So, too, did TASCO's obligation to pay Debtor any excess crop proceeds arise at the contract's inception. Accordingly, even though the amount of the final installment payment from

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TASCO to Debtor was necessarily computed after Debtor filed for relief, the right to receive such payment existed prepetition. Thus, the requirements of Section 553 that both debts arise before the commencement of the bankruptcy case is satisfied.

TASCO is entitled to offset the final installment payment due to Debtor under the Owyhee County Agreements against Debtor indebtedness under the Payette County Agreements. Although Section 553 preserves TASCO's right to setoff in bankruptcy, under the statute such right is subject to the Section 362(a)(7) automatic stay. However, from the evidence it appears that TASCO has not effected a setoff, nor violated the automatic stay, by withholding payment of the final installment. *Citizens Bank of Maryland v. Strumpf*, ___ U.S. ___, ___, 116 S.Ct. 286, 289 (1995). However, under *Strumpf*, TASCO is admonished to formally request relief from the stay promptly in order to exercise its right to setoff.

TASCO's application of the \$8,788.01 in beet proceeds from the Payette County farm against Debtor's indebtedness on that operation does not fall within the

purview of Section 553, however.⁶ One of the defining characteristics of setoff is that "the mutual debt and claim . . . are those arising from different transactions." *Newbery Corp. v. Fireman's Fund Ins. Co.*, 95 F.3d 1392, 1398 (9th Cir. 1996). In this case, both obligations, Debtor's liability for the advancements and TASCO obligation to distribute the net proceeds, arose out of a single integrated transaction: the Payette County operation and the underlying Agreements. Thus, the Court finds that the matter falls outside the ambit of Section 553.

Notwithstanding the inapplicability of Section 553, however, TASCO was entitled to deduct the proceeds from Debtor's indebtedness on the operation. TASCO contends that the application of the crop proceeds against the advancements on the Payette County farm is founded in the equitable doctrine of recoupment. However, the Court concludes that although the recoupment doctrine would apply to defend against Debtor's claim to the proceeds as

⁶ As noted above, after Debtor filed his bankruptcy petition, TASCO issued to Debtor a Growers Accounting Statement for the Payette County property on which Debtor had suffered the net loss. As evidenced by the statement, TASCO had already applied \$8,788.01 in beet proceeds against the indebtedness.

discussed below, the issue is controlled by the parties' express agreements on the Payette County operation.

Under the provisions of the Payette County Agreements, TASCOCO was obligated to distribute the crop proceeds only to the extent that the 1995 crop proceeds exceeded advancements. Likewise, Debtor was indebted to TASCOCO only to the extent that the advancements exceeded crop proceeds. Obviously, the parties were required to reconcile the account on the Payette County property in order to come to proper determination of the amount due, by either party, on the operation.⁷

In this case, crop proceeds fell short of advancements. Under the Agreements, then, TASCOCO was entitled to deduct the \$8,788.01 from the advancements to reduce Debtor's indebtedness to TASCOCO. This allows the parties to come to a proper determination of the amounts due and owing on the Payette County operation. While it is true that some portion of the shortfall results from the dismal results of the 1994 season on the Payette County farm, such

⁷ See Memorandum of Agreements, Security Agreements, and Loan Agreement and Disclosure Statements attached as Exhibits D and E to Debtor's Memorandum in Support of Motion for Turnover filed February 27, 1997.

does not alter the outcome because Debtor specifically agreed to add the 1994 debt to the 1995 contract.

The same result would be reached under the doctrine of recoupment. In contrast to setoff, recoupment involves the netting out of debt arising from a single transaction. The debt may arise either before or after the commencement of the case. *In re Harmon*, 188 B.R. 421, 425 (9th Cir. B.A.P. 1995). In addition, unlike setoff, recoupment is not subject to the automatic stay. *Newbery Corp. v. Fireman's Fund Ins. Co.*, 95 F.3d 1392, 1399 (9th Cir. 1996). Further, because recoupment only abates or reduces a debt, as opposed to constituting an independent basis for a debt, it is not a claim in bankruptcy. *In re Harmon*, 188 B.R. at 425. Justification for the recoupment doctrine is that when the creditor's claim against the debtor arises from the same transaction as the debtor's claim, it is essentially a defense to the debtor's claim against the creditor rather than a mutual obligation.

Here, TASCO advanced funds to Debtor under the Payette County Agreements to be used in the production of his Payette County sugar beet crop. Debtor's claim against

TASCO arose after delivery of the 1995 crop to TASCO's receiving station. However, Debtor was liable to TASCO for the advancements, and such advancements greatly exceeded crop proceeds. The doctrine of recoupment, as applied here, would insure that Debtor is only allowed to recover those amounts just and properly due. Thus, the doctrine would also apply to defend against Debtor's claim to the \$8,788.01.

Issues Not Resolved by this Decision.

There are several potential issues discussed by the parties in their pleadings and at the hearing on Debtor's Motion and Objection that are not finally resolved by this decision.

First, as noted above, the Court makes no final finding concerning the accuracy of the total amount claimed to be due from Debtor to TASCO as stated in its proof of claim. If Debtor, the Trustee, or other interested parties intend to formally dispute the amount claimed to be due, they may file a supplemental objection to TASCO's proof of claim on that basis.

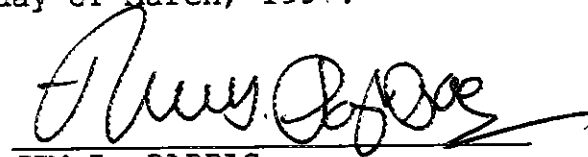
Next, the Court does not here finally determine the extent or amount of TASCOS allowed secured claim. TASCOS claims a security interest in crops, but there is some question whether that security interest was properly perfected. Moreover, the Court makes no findings as to the value of any other collateral, such as equipment, TASCOS contends secures its claim. These matters must also be addressed separately, or possibly, in connection with confirmation of Debtor's proposed plan.

Finally, the Court was informed that TASCOS and Landview Fertilizer entered into certain subordination or similar agreements regarding the parties' respective rights in Debtor's crops. Any disputes arising from those agreements are likewise matters saved for another day.

Conclusion.

Counsel for TASCOS may submit an appropriate form of order denying Debtor's Motion for Turnover and Objection to Claim as the same relates to the proceeds from the Payette and Owyhee County beet crops.

DATED This 18th day of March, 1997.

A handwritten signature in black ink, appearing to read "Jim D. Pappas", written over a horizontal line.

JIM D. PAPPAS
CHIEF U.S. BANKRUPTCY JUDGE

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CERTIFICATE OF MAILING

I, the undersigned, hereby certify that I mailed a true copy of the document to which this certificate is attached, to the following named person(s) at the following address(es), on the date shown below:

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CASE NO.: 96-02095

CAMERON S. BURKE, CLERK
U.S. BANKRUPTCY COURT

DATED: 3-18-97

By *Ma Anne J. Fitus*
Deputy Clerk

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